The changing nature of the financial system in Mexico: the allocation of finance, long-term growth and policy measures

Bank of Mexico

The Mexican financial system remains strong and has exhibited considerable soundness and resilience over the past several years, managing to navigate several episodes of stress. It holds assets equivalent to 98% of GDP and has posted consistent growth for the last decade (5.5% annual growth as of March 2024). The financial system is bank-centred, with the commercial banking sector accounting for 44% of the system's assets. Meanwhile, pension funds account for 20% of the total, followed by investment funds with 11%, development banks with 10%, insurers with 8% and brokerage firms with 4%. The commercial banking sector has a strong presence of foreign subsidiaries and holds high capital and liquidity buffers. Five of the seven domestic systemically important banks (D-SIBs) are foreign-owned subsidiaries that account for a substantive share of their parent-group profits. Six development banks (DBs) fill market gaps by financing long-term projects such as infrastructure investments, small and medium-sized enterprises (SMEs), exporters, housing and low-income populations. These development banks generally rely on wholesale funding. Pension funds are the leading institutional investors, followed by investment funds and insurers.

The Mexican financial system is highly integrated with global financial markets. Foreign investors hold about 15% of the outstanding local currency government bonds, though their share has been declining in recent years. The Mexican peso (MXN) is widely used as a proxy for emerging market (EM) currencies. Trading volumes of MXN in major exchanges are significantly higher than those of most other EM currencies. Capital and bond markets are modestly sized and dominated by sovereign securities. Mexico experienced capital outflows and a sharp exchange rate depreciation during the Covid-19 pandemic. Still, the overall spreads of risky financial assets were low, market functioning was orderly and, most importantly, the financial system remained resilient during that period.

The allocation of finance and long-term growth

Foreign capital generates several benefits for emerging market economies (EMEs). These economies typically have lower savings rates than their developed counterparts. Thus, foreign capital allows EMEs to supplement their domestic savings with external resources to finance investment, promoting productivity and capital accumulation. Moreover, foreign investors have more diversified portfolios, which provide financing projects with higher risk but also higher profitability and productivity. Thus, these resources can be beneficial in the long run, as they can boost the potential output of an economy.

The benefits of increasing foreign capital flows depend on several factors. One key factor is the allocation of external resources and their impact on productivity. If resources obtained through foreign capital are directed towards projects or sectors that yield high profitability and enhance productivity, the benefits for economic growth will be more important. In addition, since a share of foreign capital is directed towards sovereign debt financing, it has been beneficial to free up a portion of domestic savings to support investment projects in other sectors of the Mexican economy, particularly in small and medium-sized firms; and it has also broadened the array of financial instruments available within Mexico's financial system. However, if the influx of foreign capital distorts relative prices and encourages the accumulation of financial imbalances, it may lead to macroeconomic and financial downturns. Examples of such scenarios are the financial and economic crises Latin America faced in the 1980s, which were closely related to the dynamics of foreign capital. Thus, it is important to closely follow these inflows to make sure no such imbalances appear.

Another advantage of gaining access to foreign capital is that it typically comes hand in hand with increased accountability on the part of policymakers. Enhanced access to these resources, coupled with a robust macro-financial framework supported by responsible public policies, can stimulate the development of the financial system in EMEs and yield additional benefits such as achieving greater economic growth that can be further amplified if, for example, competition, market discipline and financial inclusion are fostered.

For instance, following the 1995 Tequila crisis, Mexico implemented significant economic and financial reforms that positively impacted the development of its bond and capital markets. These advances occurred gradually, enabling the Mexican government to develop and adopt a debt management strategy. This strategy allowed the economy to shift from foreign currency debt to domestic currency debt, diversifying bond issuance in foreign currencies other than the US dollar, extending debt maturities and creating a longer, more liquid government yield curve. Consequently, increased access to foreign capital, a robust macro-financial framework and an autonomous and accountable central bank allowed Mexico to develop and fortify its financial system. This, in turn, enhanced financial stability and mitigated both the first- and second-order effects of economic shocks.

Excessive finance, resilience and long-run growth

The relationship between exposure to international finance, macroeconomic volatility and its impact on long-term economic growth hinges significantly on the quality of an economy's macroeconomic framework and the effectiveness of its policies. For example, when an economy accumulates high levels of external debt, especially if it is denominated in foreign currency, it becomes vulnerable to fluctuations in exchange rates and global financial shocks. Moreover, a heavy reliance on foreign capital inflows introduces elements of instability due to the inherent unpredictability of these financial flows. The situation may be further exacerbated in economies with underdeveloped financial markets, where the influx of international capital can increase volatility and broaden economic imbalances.

In this regard, various economic and institutional channels play a pivotal role in mitigating the potential adverse impact of international financing on macroeconomic volatility. A credible and independent monetary policy as well as responsible fiscal policies are key factors in alleviating the effects of volatility. Effective financial regulators are also crucial for managing and mitigating the risks associated with financial market volatility. Additionally, factors such as political stability and high-quality governance are essential for maintaining and enhancing the confidence of foreign investors. All these elements are fundamental in establishing a robust macro-financial framework that enables increased exposure to external financing without triggering macroeconomic and financial instability, ultimately contributing to long-term economic growth.

As an EME, Mexico is susceptible to reactions from global financial markets due to its significant exposure to external financing. However, it is essential to note that Mexico has established well-structured adjustment processes for such events, based on its robust macro-financial framework (price stability, fiscal discipline and a strong financial system, along with ample international reserves to foster the orderly functioning of markets during shocks). Additionally, Mexico's extensive and diverse investor base further contributes to an orderly adjustment, enhancing the liquidity and depth of local financial markets. While a higher exposure to global markets could increase volatility in the short run, there is no doubt that, if it is well managed and comes along with a sound macro-financial framework, it diminishes volatility in longer terms.

Notwithstanding the safeguards, no silver bullet allows an economy to open to foreign capital and reap its benefits while remaining shielded from potential external shocks originated in (or transmitted through) international financial markets. A sustained track record of consistent policymaking geared towards those goals is essential to strike a good balance between the different trade-offs. In the case of Mexico (although it is also the case in other EMEs), the robustness, coherence and credibility of the macro-financial policy framework, coupled with a flexible exchange rate regime that acts as an efficient shock absorber, can be credited with making medium- and long-term financing a reality for some sectors in the economy. Undoubtedly, the experience gathered during these decades-long process will give us a head start in coming years to remain an attractive destination for foreign capital in times of fast-paced technological innovations in the financial sector.

Digital innovation and fintech

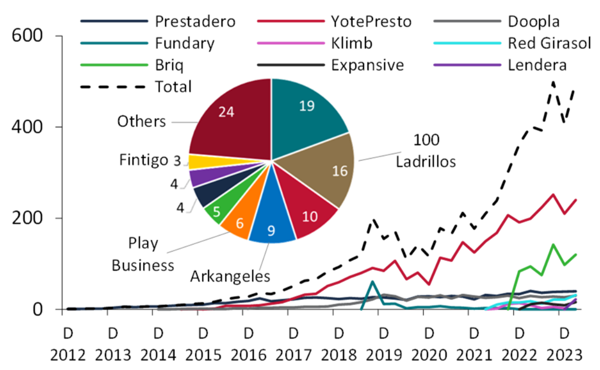
The financial industry has transformed rapidly over the last few years due to new technologies (e.g. big data, artificial intelligence, machine learning, cloud computing) and greater connectivity. Even though this process has been driven by shifting consumer behaviour for the most part (possibly linked to demographic factors, such as the usage of internet-connected devices), it is undeniable that financial services providers have also played a significant role. Moreover, because of this ongoing transformation, the relationship between users and providers of financial services has also changed and is expected to continue evolving.

These developments carry risks of their own. To fulfil our legal mandate of promoting the healthy development of our financial system, we should remain vigilant, especially in the presence of significant externalities. Industry shifts and the respective policy responses should be aligned to improve the system and, ultimately, users' welfare. For instance, given Mexico's previous history and current standing in terms of financial inclusion, one sensible approach would be to leverage the digitalisation of financial services to close the remaining gaps.

Fintech is a booming industry in the Mexican market, and increased competition in and from this sector has motivated incumbent banks to invest in digital technologies and evolve rapidly to attract new clients that entrant non-bank digital firms might otherwise attract. Despite the strong growth in fintech institutions, this sector's funding is still small relative to traditional banks although it is similar to other non-bank financial institutions (Chart 1).

Chart 1

Funding granted by institution: crowdfunding institutions[1]
In millions of pesos

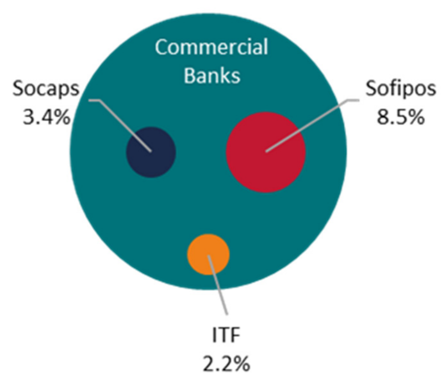


Data as of March 2024.

[1] The pie chart denotes the proportion of capital contributed by crowdfunding lenders compared to the total (in percent). The colours in both the pie -slices and the time series' lines correspond to the ones next to the entity names on top.

Source: Institutions' websites.

Relative size of financial intermediaries compared to commercial banks[2]
Percentage in terms of total equity



Data as of March 2024.

[2] The pie chart denotes the proportion of capital contributed by crowdfunding lenders compared to the total (in percent). The colours in both the pie -slices and the time series' lines correspond to the ones next to the entity names on top.

Source: Institutions' websites.

Mexican fintech law

Given the importance of this sector, Mexican financial authorities considered the need to issue a fintech legislation. The Mexican regulators – the National Banking and Securities Commission (CNBV); the Ministry of Finance (SHCP); and the Bank of Mexico – drafted a joint proposal for a financial technology law (known as the Fintech Law), which the Senate approved in March 2018.

The Fintech Law was introduced to create conditions for the sector to evolve in an orderly way based on a client protection perspective that would allow greater financial inclusion. In particular, the objectives of this law were twofold. First, to create a legal framework that provides certainty and protection to its users and promotes the sector. Second, to regulate financial activities carried out with these new technologies, particularly with institutions focused on crowdfunding, e-money and crypto asset activities.

Given the inherent risks that this sector may represent to financial stability and the sector's dynamism, the Fintech Law was based on certain ruling principles that would provide authorities with greater flexibility to regulate. These principles include financial inclusion, consumer protection, increased competition, preservation of financial stability and anti-money laundering/combating the financing of terrorism (AML/CFT).

The main aspects regulated by the Fintech Law seek to limit the scope of collective financing institutions (crowdfunding) and electronic payment institutions (e-money) where the resources for these types of lending alternatives are akin to deposits, since there is no deposit protection framework in place like the one for bank deposits. Nonetheless, it is recognised that these platforms' clients need certain level of protection. In particular, the Law oversees the following services: crowdfunding and peer-to-peer (P2P) lending, e-money services, virtual assets (cryptocurrencies), application programming interfaces (APIs) and open banking. For instance, the CNBV authorises the licences of fintech institutions, whereas for operations with virtual assets, the Law does not regulate them directly, but rather their use by financial institutions.

The Fintech Law would not cover other financial digital services pertaining to unregulated activities. For example, insurance is a regulated activity, so its digital implementation would still fall under the insurance regulator's scope.

Previous efforts

The pandemic set a fertile ground for a faster digitalisation of financial services, especially in digital banking. The Bank of Mexico has made various proposals to increase digitalisation in financial services, which is a challenge given the size of the informal sector in Mexico. In 2019, the Bank of Mexico implemented a digital payment system through quick response (QR) codes named CoDi. It has become a part of our policy efforts to increase financial inclusion and reduce the amount of cash used in the economy, which is quite large for a country where the informal sector accounts for 55% of total employment. Unfortunately, the considerable informality compounds with poor financial education and other cultural traits to make the generalised adoption of CoDi a challenge, mainly because a bank deposit account is a prerequisite for both the sending and the receiving ends of a CoDi transaction. The recently launched mobile money scheme (DiMo, for its Spanish acronym) is a new service that allows money transfers between two mobile phone users without additional information requirements. Finally, in line with several other central banks, the Bank of Mexico has been analysing and assessing the pros and cons of introducing a central bank digital currency (CBDC).

New entrants

Since the onset of the pandemic, new credit card digital lenders have evolved their business in the current high interest rate environment towards deposit-taking as part of the financial services they offer. Some institutions have been doing this by acquiring licences for microfinance deposit-taking intermediaries, similar to banks (popular savings and loan institutions) catering to the unbanked segments of the population.

The fight over retail deposits has triggered fierce competition in terms of interest rates being offered. Some licensed formal digital banks have responded with similar deposit products. Authorities must remain vigilant on the outcomes of this competition strategy by new entrants, as it relies on the assumption that they can promote growth while maintaining a healthy loan portfolio and complying with loan origination standards. If loan portfolios deteriorate in terms of credit quality, these entities may not produce the necessary margins to pay depositors in the medium and long term at the rates that they are offering. Their main vulnerability is that their credit models have yet to be tested, unlike traditional banks' models. While entrants and incumbents have ample capital levels, this can change if economic activity suffers a downturn that impacts borrowers' disposable income through adverse effects on employment. Thus, authorities must monitor the evolution of these institutions, particularly newcomers, because Mexican banks are in a better position as they mainly serve formal sector individuals and firms.

Benefits from financial digitalisation

There are significant potential benefits of digitalisation for financial inclusion and investment. The positive impact on unbanked and underbanked segments of households and firms (especially SMEs) may be considerable if loan origination and risk management are done properly. This could also increase tax compliance, as digital transactions can be monitored by authorities. However, considering the significant share of informality and the considerable incentives to remain outside the fiscal authority's radar, adoption could slow down at some point and not be as broad as expected from the current growth trend.

One area where there could be an especially positive impact in Mexico, besides the credit sphere, is insurance services. These services have low penetration, individuals (as well as firms) do not fully grasp the benefits of risk-sharing via insurance contracts, and premiums are perceived as high. A public policy mandating insurance contracts to cover certain risks (third-party liability) would be likely to increase activity and insurance penetration through competing digital platforms while increasing transparency and financial education on these products.

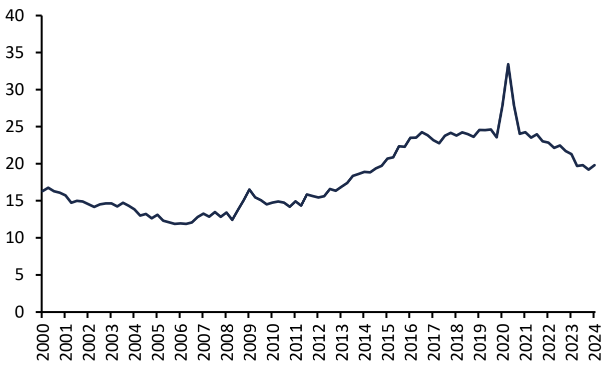
The good news is that the increase in competition and innovation is so dynamic that benefits are expected to be seen in the very short run. In that regard, authorities must step up supervision and regulation to stay on top. New risks may also arise, especially those related to cyber security. Authorities need to update their regulatory and supervisory processes as they face a significant increase in the number of participants.

Allocation of finance for long-term growth, including capital markets

Mexico's capital markets remain small and subdued, like many among EMEs. Regulatory changes in the past 15 years have been essential to create investment instruments that expand households' and firms' alternatives, especially towards long-term products. Nonetheless, there have been recent episodes of firms delisting from the stock exchange, low activity and illiquidity in both the stock and debt markets and low interest on the part of large, consolidated companies in accessing capital markets to obtain more financing that could enhance their investment and broaden their activity. This also means that, in general, public investors remain outside of the stock market as demand is low and financial inclusion is limited. Hence, the Mexican capital market is small (Chart 2) and its turnover is low compared to its peers; in addition, volume is highly concentrated in a few issuers (Chart 3). Lack of financing may also explain low fixed investment rates in the economy.

Chart 2

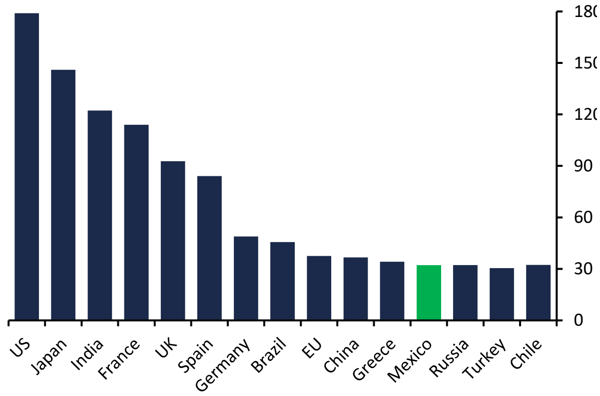
Credit to non-financial Mexican firms
as a percentage of GDP



Data as of March 2024.

Source: Bank of Mexico.

Stock market capitalisation
as a percentage of GDP

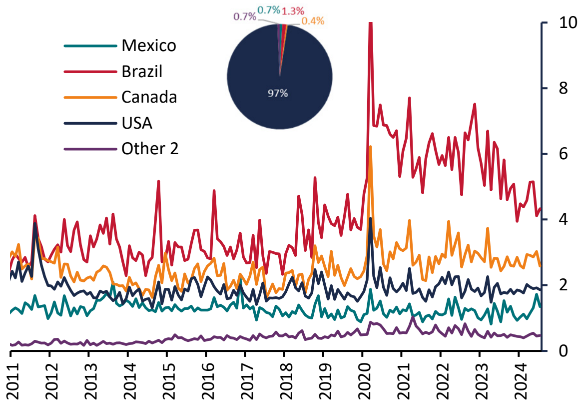


Data as of 2023.

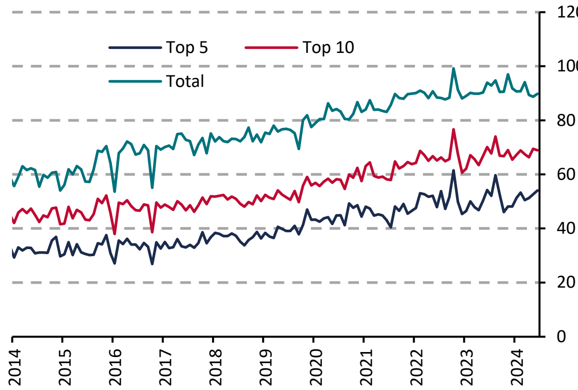
Sources: World Federation of Exchanges and World Bank.

Chart 3

Stock daily turnover of selected stock exchange markets[1]
Times market capitalization



Concentration of traded volume in Mexican Stock Market
Percentage



Data as of June 2024.

[1] Three-month moving average. [2] Includes Argentina, Chile, Colombia and Peru.

Sources: Bloomberg and Bank of Mexico.

Mexican regulators (the CNBV, SHCP and Bank of Mexico) and industry associations have assessed this environment in recent years and deemed it necessary to address existing shortcomings, on both the demand and the supply side. In November 2023, a reform advocated by all stakeholders was approved by the Congress and is expected to have positive effects in the short term, following publication of the necessary secondary regulation.

Among the shortcomings targeted by this reform are the strict requirements for firms to become public, making it costly to comply, even for some large and medium-sized firms. To this end, a simplified regime was created to attract medium-sized and even small firms seeking financing, along with other measures taken to increase market liquidity for both listed stock and public debt markets.

On the supply side, the simplified regime will help reduce the time it takes for small and medium-sized firms to issue debt or equity in the local public market. To achieve this, the new rules grant flexibility in entry requirements, allowing the issuance of common stock – and other types of ownership alternatives with variations in voting rights – to avoid hostile takeovers (a concern for large family firms, for example). At the same time, they limit the set of investors that may take this debt and equity to qualified investors, thereby limiting risk-taking to proficient clients. The reform also incorporates some due diligence responsibilities on broker-dealers and the stock exchanges, instead of leaving them to the securities regulator to stamp the issuances. This reduces the public perception of authorities endorsing the quality of the issuances and the associated false sense of security. Securities and broker-dealer firms will now have this responsibility facing their clients. This will align incentives as broker-dealers would incur the reputational cost of offering products that go against their clients' interests. With this reform, a mechanism similar to the United States Reg 144-A is open to SMEs that want to access institutional investors' financing.

On the demand side, provisions have been made so that specific institutional investors have access to new debt and equity issuances. In this regard, within this reform hedge funds have been included for the first time in the law. Other changes for the investment fund sector include adopting best international practices, which is likely to increase transparency. Some changes in the secondary regulations may be needed to fully exploit the potential of the new securities market law.

Lastly, another relevant capital market development that is likely to provide benefits is the consolidation of an ESG debt market. This market has grown notably in the last year and is expected to represent more than half the outstanding balance in the local long-term debt market soon. Indeed, our previous experience developing a long and liquid government bond yield curve will help us guide our efforts for a similar outcome in the ESG case.

Conclusion

A fast-evolving financial system plays a very relevant role in fostering investment, which can, in turn, bolster economic growth. It is vital to leverage the benefits from international capital markets, as they could fund productive projects and foster long-term economic growth in the presence of sound economic fundamentals. To fully grasp the benefits of international markets, it is crucial to participate in them while maintaining sound local financial markets and a deep financial system, thereby creating multiple investment channels for households and firms of different characteristics. In this regard, the Mexican financial system is experiencing growing participation by fintech institutions that can foster financial inclusion and depth provided their growth is overseen by authorities to prevent undue accumulation of risks and ensure sound consumer protection. Finally, the regulatory framework for local financial markets is also being reformed to facilitate wider participation of firms, particularly SMEs. Overall, the evolving financial landscape should create fertile soil for the more extensive involvement of economic agents in funding productive projects and economic activity